REPORT TO:	**FINANCE and MANAGEMENT COMMITTEE**	**AGENDA ITEM: 9**
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REPORT FROM:	**CHIEF EXECUTIVE OFFICER**	
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SUBJECT:	**HOUSING REVENUE ACCOUNT SELF FINANCING: TREASURY MANAGEMENT OPTIONS and ACCOUNTING ISSUES - UPDATE**	**REF:**
WARD (S) AFFECTED:	**ALL**	**TERMS OF REFERENCE: FM 08**

1.0 Recommendations

1.1 That in principle the Settlement Debt is borrowed from the Public Works Loan Board on the most advantageous terms available.

1.2 That the options for borrowing any further debt up to the Debt Ceiling are at this stage kept under review.

1.3 That based on 1.1 and 1.2, a revised Treasury Management Strategy is drawn up and reported to the Committee in January 2012.

1.4 That specialist Treasury Management advice is procured to support the Strategy.

1.5 That the final Treasury Management Strategy and Prudential Indicators are reported to Full Council on 28th February 2012 following notification of the final settlement figures and the level of housing rents for 2012/13.

2.0 Purpose of Report

2.1 To provide a detailed review of the borrowing options available to the Council in taking on debt as part of the Government's self-financing proposals for the Housing Revenue Account (HRA).

2.2 This follows the update provided to the Committee in June 2011 on the detailed methodology and financial parameters issued by the Government in February 2011.

2.3 The report also provides an update on further proposals for the accounting issues associated with the self-financing framework.

3.0 Detail

Background

3.1 As previously reported, from April 2012, the current housing subsidy system (subject to the Localism Bill) will cease and the HRA will become self-financing. The Council will be able to keep all future rental income to meet the investment needs of its housing stock together with day to day management, etc.

3.2 The introduction of self financing is based on a valuation of the stock and appropriate settlement, either payment or receipt, to the Government to buy out of the subsidy system. Each council will commence with a level of debt representative of the value of its stock which is expected to be sustainable over a 30-year business plan.

3.3 At present, the Council's debt settlement is **£54.8m.** Its debt cap, which will be fixed at the outset of the settlement, is **£64.2m**. This cap is higher by £9.4m. The Council's underlying borrowing requirement against this cap for the HRA in the current subsidy system is **£2.1m.**

3.4 Consequently, the Council has "headroom" to borrow an additional **£7.3m** (£9.4m less £2.1m) in the HRA in addition to the main debt settlement. Actual settlement day has been set for 28th March 2012. The Council will need to arrange borrowing on or shortly before this date to pay the Government £54.8m.

3.5 The headroom can be used at the discretion of the Council at anytime, subject to it complying with the national Prudential Borrowing Framework. Effectively, the Council would need to demonstrate that any additional borrowing is affordable within the HRA's Business Plan.

3.6 As previously reported, the Council considered and approved a 30-year business plan earlier in the year. As part of this, tenants expressed aspirations to undertake some additional investment. A level of prudential borrowing of £4.3m (against the £7.3m) has therefore been included in the business plan to fund these investments.

3.7 In addition, a further report elsewhere on this Committee's Agenda proposes to use a sum of £1m to install Photovoltaic Panels on council properties. This would be funded by prudential borrowing but would count against the headroom of £7.3m, leaving £2m (£7.3m less £4.3 less £1m).

Funding the Debt

3.8 The Business Plan requires initial funding of £54.8m to make the payment to the Government to buy out of the subsidy system on 28th March 2012. Prudential borrowing of £4.3m is within the Plan (plus £1m for Photovoltaic Panels) and current debt of £2.1m is internally funded.

3.9 Overall these amounts total **£62.2m** which is below the debt cap of £64.2m.

Borrowing Options

3.10 Although nationally the amount of the Council's debt take-on is small, it is a substantial amount for a district council. The Council will need to balance certainty with ensuring that it gets the right deal within the affordability of the Business Plan.

3.11 Some borrowing sources will come with greater certainty and hence lower risk, but could be more expensive as a consequence; other sources will offer a lower cost, greater diversity but through more complex arrangements, the risk will be greater.

3.12 Principally, there are two sources of funding, internal and external. The following sections provide an overview of each option with the risks and benefits compared to each other. With any treasury management activity, there is always some risk.

Internal Borrowing

3.13 The HRA can "borrow" from the General Fund based on the Council's internal rate of interest. This is currently around 1%. Effectively, the HRA would borrow against funds that the Council has on deposit which effectively is currently happening with the underlying borrowing requirement in the HRA of £2.1m.

3.14 However, this would only be a short term option as the Council's funds on deposit change during the year although, generally, the Council does maintain cash on deposit through its level of reserves and other retained funds. This tends to average £4m per year.

3.15 Clearly this would not be an option to fund the debt settlement of £54.8m in total. However, it is certainly an option for any prudential borrowing.

3.16 The main benefit is that the interest charged to the HRA would be more than the interest currently being received on the deposits foregone. In turn the HRA would be borrowing less than that assumed in the Business Plan.

3.17 The main drawback is that it is not flexible. The Council may not be able to choose the moment at which the HRA replaces these funds. The timing could be forced by General Fund needs and the call on its resources - cash flow requirements can change quickly.

Internal Borrowing: Benefits v Risks

Benefits	**Risks**
• Simple • Deposit interest foregone should be less than cost of borrowing	• Defers any borrowing to when rates may be higher • Inflexible – cash becomes unavailable or is withdrawn at short notice

External Borrowing

3.18 The debt can be funded through the Public Works Loan Board (PWLB), using funds acquired in the market from commercial lenders or through a bond issued by the Council.

PWLB

3.19 The PWLB is the main funder of most local authority debt (80%). It is flexible, convenient and until the last Government spending review in 2010, was the cheapest source of funding available to the majority of councils.

3.20 However, the recent announcement by the Chief Secretary to the Treasury indicated that interest rates would be lowered for councils just to finance the debt take on. Based on current interest rates, this will be lower than other forms of borrowing..

3.21 The PWLB provide loans with differing repayment structures:

- **Maturity Loans** – interest only over the period of the loan and the principal in total is repaid at the end of the loan term.

- **Equal Instalments of principal (EIP)** – where the loan is repaid in equal amounts each year over the period of the loan and interest is paid on the amount outstanding of the loan each year.

- **Annuity** – this is where an equal amount is paid each year with repayments split between interest and principal. This spilt varies over the loan term with smaller amounts of principal being paid in the early years, increasing to repay the loan in full by the end of its term.

3.22 The PWLB provides loans on a fixed or variable rate of interest for maturity and EIP loans. The longer the term of the loan, the higher the rates demanded.

3.23 Maturity loans attract higher rates of interest as the principal is not repaid until the end of the loan term. EIP loans are available at lower interest rates as the principal is repaid over the loan period.

3.24 There are no initial and on-going legal or other complex terms to negotiate. The only costs are the initial arrangement fees.

PWLB: Benefits v Risks

Benefits	Risks
• Simple process – can be achieved through a phone call with low set-up fees • Flexible – can switch between repayment structures, fixed and variable rates and also loan periods at a low cost • Certain – PWLB are the lender of "last resort" • Same pricing regardless of type of organisation and standing • Low administrative costs for the borrower	• Could be more expensive than other forms of borrowing • Potential for legislative changes resulting in increased cost or reduced flexibility

Market Loans

3.25 The current financial uncertainty in the general economy has resulted in banks and financial institutions being unwilling or unable to deliver funding to local authorities. Where they do, then the rates at which it is offered are uncompetitive, being 1-2% higher than PWLB.

3.26 Although similar repayment models to the PWLB exist, loans tend to be negotiated. Interest rates will depend on the institutions view of the risks in the business plan. Variable rate loans will be lower than fixed rates as the interest rate risk is with the borrower.

3.27 It is possible that more banks may enter the market over the next few months as municipal housing has always been attractive to certain lenders. It may be possible to obtain a tailored debt proposal that fits the Business Plan and provides VFM.

3.28 There are some offerings currently been made which are purported to be 0.2% cheaper than current PWLB rates and there are some offering loans with interest rates linked to inflation. The structures of these types of loans are usually very complex and need close examination and careful evaluation before taking forward. The costs of this arrangement are:

- Understanding and evaluating offers
- Legal costs for loan documentation
- Arrangement fees
- Negotiation
- On-going costs of external accountability to the lender including scrutiny of the Business Plan and investment proposals

Market Loans: Benefits v Risks

Benefits	Risks
• Diversification of the loan portfolio • Possibly cheaper interest rates • Certainty over loan period • Can tailor loans, e.g. fixed and variable elements	• Complex process to negotiate terms and • Legal documentation substantial • Regular scrutiny by the lender of the Business Plan • Flexibility, e.g. to renegotiate terms, comes at a substantial cost and could be restricted to loan covenants • Terms on offer may be of a short duration, i.e. not 25 years • Complicated and complex arrangements requiring close examination and scrutiny by the borrower

Bonds

3.29 Bonds are a loan instrument issued to the market with a fixed coupon rate. Current rates could be over ¼% lower than market and PWLB rates making them very competitive for long-term, high principal debt.

3.30 Bonds can be sold through a public issue which can then be traded on in future or a private issue to one investor who usually holds to maturity. For a public issue the minimum amount would be £150m; private issues can be for lesser amounts although this would come with a higher margin, eroding any advantage.

3.31 To issue a bond it is usual to gain a credit rating for the coupon rate to be determined. The lower the rating received the riskier the bond is seen and therefore attracts a premium.

3.32 Obtaining a rating is an intensive process with an uncertain outcome and is reviewed annually. Ratings can be avoided for issues less than £50m, although this will attract a risk premium.

3.33 Issuing the bond is also a complex process requiring intermediaries. They are issued off shore for tax purposes.

3.34 The lead in time is lengthy with no guarantee of what the interest rate will be until the day of issue. The timescale required would not allow a bond to be issued between now and April 2012.

A Bond Consortium

3.35 This adds complexity and time to the process. The rating has to be completed for all organisations with the consortium. It would be desirable for all organisations to achieve the same rating to ensure the bond has a consistent rating, although this may not be the case.

3.36 There are proposals in the market at present to overcome this problem and develop a mechanism for the bond to be rated rather than the institutions. These are not yet operational or tested; indeed the issue of bonds on such a global scale within government generally, within the UK, has a very limited track record.

3.37 These have tended to be for substantial capital and infrastructure investment where some of the costs involved have been "paid back" through income generation.

3.38 The Local Government Association is currently consulting councils to determine the feasibility of a business case to create a local authority bond consortium. This could take up to 2 years to evolve and be implemented.

3.39 The costs of the bond process are:

- Obtaining the rating and maintaining it
- Issuing fee
- Legal costs
- Time in administering and monitoring the arrangement

Bonds: Benefits v Risks

Benefits	Risks
• Diversification of the loan portfolio • Probably cheaper interest rates • Certainty over loan period • Fixed cost of borrowing	• Complex process with no certainty that final issue will be successful • Pricing only known at date of issuance – could be subject to market conditions • Internal skills and costs required for administration • Could be dealing with many stakeholders • Inflexible if redeeming early, would need to buy back at the prevailing market price. • High costs of set up

Derivatives

3.40 These are financial instruments, such as interest rate swaps, that are used to manage risks in a debt portfolio. The Localism Bill will give local authorities limited power to use these as part of an overall treasury management strategy. The extent and scope of this power is still to be detailed.

3.41 Although set-up costs are not high, the operation of such instruments is extremely complex. Although interest can be reduced considerably, the risk is high and premiums can be expensive where interest rates move against that agreed.

Comparison of the Options

3.42 To illustrate the relative cost of the main options a comparison of net present values over a 30-year loan has been made. This shows the cost of funding the initial debt take-on of £54.8m. The assumptions are on a basis of current PWLB interest rates for the various types of loan, with a discount on a bond at 0.2%.

3.43 All costs over the term of the products have been included. Although interest rates could vary, the relative cost of each option should not significantly change.

3.44 The detailed calculations are shown in **Appendix 1**. The summary results are shown in the following table based on a range of discount factors to calculate the net present value (NPV) of cash flows, i.e. to take account of the value of money depreciating over time.

NPV over 30 years (£m)	Bond	PWLB Annuity	PWLB Maturity	PWLB EIP
6.5% Discount Rate	46.0	46.0	44.7	46.6
6% Discount Rate	49.1	48.5	47.9	48.8
5.5% Discount Rate	52.7	51.2	51.5	51.1

3.45 A discount rate of 6.5% is that used by the Government in the valuation of the housing debt settlement. The PWLB Maturity option is the best option on this basis although the margin erodes at lower discount rates.

3.46 **Appendix 1** also shows the cost in overall cash terms at today's prices and this is summarised in the following table.

Option	30-year Cost (£m)
Bond	138.4
PWLB Annuity	105.7
PWLB Maturity	138.4
PWLB EIP	95.3

3.47 The cheaper cost of interest on a Bond is eroded by initial set-up fees. The PWLB EIP loan has the lowest cost taking £95m out of the business plan over 30 years compared to a Maturity Loan or Bond at a cost of around £138m. This is because principal is paid back over the life of the EIP loan reducing longer term interest payments.

Funding the Business Plan

3.48 The approved business plan has not taken account of how the debt will be funded. It operates in effect an "overdraft" arrangement where all outstanding cash is applied to repay debt and reduce interest. This is the same assumption made within the financial model provided for the Government.

3.49 In reality, the business plan will be funded substantially through fixed term debt as detailed above. Based on the resources available from the business plan to fund debt, the funding options (above) have been modelled to determine their affordability.

3.50 Effectively, additional resources will be generated on self-financing as the interest payments assumed in the business plan are less than the current amount paid to the Government in negative subsidy

3.51 However, the business plan is under more pressure over the early years due to the additional resources required for investment in the stock to maintain decent standards. In addition, the full effects of rent restructuring, which will increase overall rent income, will not be available until 206/17.

3.52 Therefore, besides funding interest, the business plan cannot also afford to start repaying debt until years 5 /6. Although the cheapest option previously modelled over 30-years was the EIP option, the plan could not afford to make the associated principal repayments.

3.53 Maturity loans ensure that these early years of the business plan can support debt and investment. Several loans could be taken and spread out over varying periods. This would provide a tailored portfolio and provide options for debt rescheduling in the future.

3.54 Some debt could be taken at a variable rate, although there is a risk that rates will increase and erode the margin compared to fixed rates. However, current interest rates are at a historically low level and there are many arguments for progressing borrowing early and to fix now to insure against the future.

3.55 The PWLB have agreed to issue variable rate loans for less than 12 months (normally they are not offered for such short periods) if councils want a “bridging loan” prior to taking on the debt.

3.56 There would be a risk in taking advantage of this facility and delaying the decision on funding to later in the year as long term rates may increase in the meantime. The current historically low level of interest rates is a compelling factor in any decision.

Other Treasury Issues

3.57 Whichever instruments and options are chosen to fund the business plan, there will in the future need to be active management of the debt portfolio. The profile of investment could change or opportunities may arise to advantageously refinance debt, including for example, swapping into the Bond market.

3.58 With a debt portfolio of over £60m to manage, this will require some external expertise and advice. A provision to engage Treasury advisors has been included in the business plan. Therefore, it is recommended that this is procured to support the final Treasury Management strategy and for future advice.

3.59 Clearly, the Council's current Treasury Management Strategy and Prudential Indicators will need to be revised to reflect HRA self-financing. This will be detailed and reported to the Committee in January and February 2012 as part of the budget process.

Conclusion

3.60 From this analysis, the PWLB maturity option is currently the most favourable instrument to fund the HRA business plan.

3.61 This is even more compelling as the interest rate will be much lower for debt take-on (but not borrowing against the headroom) following the recent announcement by the Chief Secretary to the Treasury.

3.62 The benefits of the PWLB is that it is safer, certain and cheaper administratively. This does not preclude other forms of borrowing in the future and the final debt portfolio should reflect this.

3.63 For example, it is likely to take the Bond market some years to mature and this would need to be kept under review in the Strategy.

3.64 The options for the headroom debt can be more flexible as it is of lower value. For example, funding it internally, especially in the short-term, will be beneficial to the HRA as a cheap source of borrowing without exposure to the market.

Final Settlement Figure

3.65 The main uncertainty is that the final settlement figure is likely to increase from the current £54.8m. This will affect all housing authorities and will reflect the current level of inflation which is in excess of 5% as measured by the Retail Price Index (RPI) in September 2011.

3.66 This will increase the value of the housing stock as RPI will be used as the basis to increase rent levels in 2012/13, i.e. it will increase the income in the national HRA and will assume rent levels, locally, will increase in line with Government expectations.

3.67 Consequently, the increased value will be reflected in a higher debt take-on. The final settlement figure will be issued in November 2011 and confirmed, subject to any amendments, in late January 2012.

Timetable and Procedure

3.68 This is set out in the following table

10th October 2011	Deadline for submission of audited base data for final settlement
November 2011	DCLG issue draft settlement figure for consultation and review
December 2011	PWLB release user guide and training for proposed transactions; all loan applications to be made via a new on-line portal

31st January 2012	DCLG issue final settlement figure and councils can then start arranging loans for debt take-on
26th March 2012	Final date on which councils can arrange loans
28th March 2012	Transactions completed between DCLG, PWLB and councils

3.69 Clearly, councils looking to arrange other forms of borrowing will need to make alternative arrangements, although they will still need to make the final settlement payment on 28th March.

3.70 The Council has registered with the PWLB in accordance with the previous timetable and will be liaising, along with the Council's Bankers in the run-up to debt take-on. It should be noted that the lower rates being offered for self-financing will only be available:

- For the initial debt take-on and not any borrowing towards the headroom, and
- On-line through the PWLB's on-line portal between January and March 2012.

Accounting Implications - Update

3.71 In February 2011, the Chartered Institute of Finance and Accountancy (CIPFA) released technical papers to consult on the potential depreciation treatment in the HRA under self-financing, together with splitting existing debt charges. This was detailed and reported to the Committee in June. CIPFA have now issued final proposals for the new accounting treatment.

Existing Debt

3.72 At present, all Council debt is pooled in the General Fund. A share of the costs is then transferred to the HRA in accordance with a prescribed formula. This formula forms part of the current subsidy system and is based on the borrowing requirement of the HRA. This does not usually match actual debt outstanding.

3.73 As previously reported, this is not considered a significant issue for the Council due to its low level of debt. This is already attributable substantially to the HRA in any case.

3.74 The accounting method to maintain this balance between the HRA and the General Fund will be determined during the forthcoming budget round and reported to the Committee in January 2012. This will include any effects of the charges not already included in the business plan.

New Debt

3.75 It has been confirmed that new debt under self-financing will be pooled and accounted for separately to ensure that there is no impact on the General Fund. However, the debt will be classed as Council Debt and the HRA will still remain a subsidiary account of the Council's General Fund.

Depreciation and Impairment

3.76 Although depreciation and impairment are currently charged into the HRA's income and expenditure account, they are reversed out below the line to avoid any impact on the "bottom line." Under self-financing, depreciation and impairment will become real costs.

3.77 There is still an on-going debate amongst practitioners around the technical basis of charges and their accounting treatment. However, in a change to previous proposals, there will now be a 5-year transition period to enable councils to establish a proper method of calculating depreciation for its housing stock
(**This is currently an assumed figure in the subsidy system based on the Major Repairs Allowance**).

3.78 Whatever the final proposals are, the key aspect with depreciation is that the Council's on-going capital investment will need to greater than the calculated depreciation.

3.79 If not, in accounting terms, this would indicate that the Council is not maintaining its stock to an appropriate or decent standard and the extra cost would need to be charged into the HRA. The current business plan assumes that the level of depreciation will be adequate but, clearly, it will need to be kept under review.

3.80 Impairment is potentially, a further concern. This is an accounting adjustment that measures the deterioration in the value of an asset, whether by market forces or through peril such a fire or other damage.

3.81 The accounting treatment proposed would in certain circumstances become an extra charge on the HRA. This is a change to previous suggestions which indicated that it would still have a neutral effect on the overall HRA. This will also need to be kept under review.

4.0 Financial Implications

4.1 As detailed in the report

5.0 Corporate Implications

5.1 No other direct legal, personnel or other resource issues at this stage.

6.0 Community Implications

6.1 Clearly, the proposals will have a significant impact upon council tenants. A representative group have been kept up-to-date and were included in the Business Plan review earlier in the year. On-going communication with all tenants is to be undertaken through established means such as the Tenant's newsletter.

7.0 **Background Papers**

7.1 Implementing Self-Financing for Council Housing:

http://www.communities.gov.uk/publications/housing/implementingselffinancing

7.2 Consultation on Proposed Capital Finance Arrangements Under the New Housing Finance System:

http://www.cipfa.org.uk/pt/download/HRA_Review_Consultation_2011.pdf